# HOUSE BUDGET COMMITTEE

## Democratic Caucus

**The Honorable John M. Spratt Jr. ■ Ranking Democratic Member**

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# International Monetary Fund: Current U.S. Policies Risk Higher Interest Rates, Slower Growth

Dear Democratic Colleague:

This week, the International Monetary Fund (IMF) issued an important report warning that the current fiscal position of the federal government may prove to be a long-term drag on growth for the U.S. economy specifically and the world economy generally. This study confirms what Democrats have been saying for some time now: that the Republicans have placed the nation on a dangerous fiscal path.

The IMF's mission is to promote and maintain the international system of currency and trade that promises increased growth and living standards worldwide. Here are some highlights of the report, entitled "U.S. Fiscal Policies and Priorities for Long-Run Sustainability," whose index and overview, as well as a transcript of the authors' conference call with members of the media, are available at www.imf.org.

- "Within only a few years, hard-won gains of the previous decade have been lost and, instead of budget surpluses, deficits are again projected as far as the eye can see." The current situation threatens to "crowd out" funds for private investment.

- The projected surpluses would have provided a vast reservoir of national savings to accommodate demographic pressures on Social Security and Medicare. Now, there is no longer a cushion to aid in a "soft-landing" for these crucial entitlements when the Baby Boom retires.

- "The United States is on course to increase its net external liabilities to 40 percent of GDP within the next few years – an unprecedented level of external debt for a large industrial country." The authors estimate that this could lead to a permanent ½ to 1 percentage point increase in real interest rates in the industrialized world and could lead to "an abrupt weakening of investor sentiments vis-à-vis the dollar."

- Increased discretionary spending was responsible for only one-quarter of the deterioration of the nation's fiscal position between Fiscal Year 2000 and Fiscal Year 2003. This includes the increased spending on defense, homeland security, and the war on terrorism.

- In previous tax-cut legislation, Congress added phase-in formulas and sunset clauses to comply with that year's budget resolution. If the tax cuts are made permanent, the deficit will increase by an additional 2 percent of GDP by 2013. (The deficit is around 4 percent of GDP today.)

- In order to avoid a future of chronic structural deficits, the federal government must (1) provide a credible framework for balancing the budget without help from the Social Security trust fund, and (2) ensure the long-term viability of Social Security and Medicare in light of looming demographic pressures.

For too long, the Administration has refused to acknowledge that its flawed and risky fiscal policies have any consequences, but this new report confirms that the consequences of these policies are indeed serious. Let us heed this warning and not sacrifice our long-term aspirations for today's political expediencies.

For your reference, I have attached yesterday's *New York Times* article outlining the report.

Sincerely,
/s
John M. Spratt, Jr.
Ranking Democratic Member

# I.M.F. Warns That U.S. Debt Is Threatening Global Stability

By ELIZABETH BECKER and EDMUND L. ANDREWS
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WASHINGTON, Jan. 7 -- With its rising budget deficit and ballooning trade imbalance, the United States is running up a foreign debt of such record-breaking proportions that it threatens the financial stability of the global economy, according to a report released Wednesday by the International Monetary Fund.Prepared by a team of I.M.F. economists, the report sounded a loud alarm about the shaky fiscal foundation of the United States, questioning the wisdom of the Bush administration's tax cuts and warning that large budget deficits pose "significant risks" not just for the United States but for the rest of the world.

The report warns that the United States' net financial obligations to the rest of the world could be equal to 40 percent of its total economy within a few years -- "an unprecedented level of external debt for a large industrial country," according to the fund, that could play havoc with the value of the dollar and international exchange rates.

The danger, according to the report, is that the United States' voracious appetite for borrowing could push up global interest rates and thus slow global investment and economic growth.

"Higher borrowing costs abroad would mean that the adverse effects of U.S. fiscal deficits would spill over into global investment and output," the report said.

White House officials dismissed the report as alarmist, saying that President Bush has already vowed to reduce the budget deficit by half over the next five years. The deficit reached $374 billion last year, a record in dollar terms but not as a share of the total economy, and it is expected to exceed $400 billion this year.

But many international economists said they were pleased that the report raised the issue.

"The I.M.F. is right," said C. Fred Bergsten, director of the Institute for International Economics in Washington. "If those twin deficits -- of the federal budget and the trade deficit -- continue to grow you are increasing the risk of a day of reckoning when things can get pretty nasty."

Administration officials have made it clear they are not alarmed about the United States' rapidly expanding external debt or the declining value of the dollar, which has lost more than one-quarter of its value against the euro in the last 18 months and hit new lows this week.

"Without those tax cuts I do not believe the downturn would have been one of the shortest and shallowest in U.S. history," said John B. Taylor, under secretary of the Treasury for international affairs.

Though the fund has criticized the United States on its budget and trade deficits repeatedly in the last few years, this report was unusually lengthy and pointed. And the I.M.F. went to lengths to publicize the report and seemed intent on getting American attention.

"I think it's encouraging that these are issues that are now at play in the presidential campaign that's just now getting under way," said Charles Collyns, deputy director of the I.M.F.'s Western Hemisphere department. "We're trying to contribute to persuade the climate of public opinion that this is an important issue that has to be dealt with, and political capital will need to be expended."

The I.M.F. has often been accused of being an adjunct of the United States, its largest shareholder.

But in the report, fund economists warned that the long-term fiscal outlook was far grimmer, predicting that underfunding for Social Security and Medicare will lead to shortages as high as $47 trillion over the next 70 years or nearly 500 percent of the current gross domestic product in the coming decades.

Some outside economists remain sanguine, noting that the United States is hardly the only country to run big budget deficits and that the nation's underlying economic conditions continue to be robust.

"Is the U.S. fiscal position unique? Probably not," said Kermit L. Schoenholtz, chief economist at Citigroup Global Markets. Japan's budget deficit is much higher than that of the United States, Mr. Schoenholtz said, and those of Germany and France are climbing rapidly.

In a paper presented last weekend, Robert E. Rubin, the former secretary of the Treasury, said that the federal budget was "on an unsustainable path" and that the "scale of the nation's projected budgetary imbalance is now so large that the risk of severe adverse consequences must be taken very seriously, although it is impossible to predict when such consequences may occur."

Other economists said they were afraid that this was a replay of the 1980's, when the United States went from the world's largest creditor nation to its biggest debtor after tax cuts and a large military buildup under President Ronald Reagan.

John Vail, senior strategist for Mizuho Securities USA, said the I.M.F. report reflected the concerns of many foreign investors.

"I would say they reflect the majority of international opinion about the United States," he said. And he added, "The currency doesn't have the safe-haven status that it has had in recent years."

Many economists predict that the dollar will continue to decline, and that the declining dollar will help lift American industry by making American products cheaper in countries with strengthening currencies.

"In the short term, it is probably helping the United States," said Robert D. Hormats, vice chairman of Goldman Sachs International.

Fund officials and most economists agreed that the short-term impact of deficit spending has helped pull the economy through a succession of crises. And unlike Argentina and other developing nations that suffered through debt crises, the United States remains a magnet for foreign investment.

Treasury Secretary John W. Snow did not address the fund's report directly. But in a speech to the Chamber of Commerce on Wednesday, he said Mr. Bush's tax cuts were central to spurring growth and reiterated the Bush pledge to reduce the deficit by half within five years.

"The deficit's important," Mr. Snow said. "It's going to be addressed. We're going to cut it in half. You're going to see the administration committed to it. But we need that growth in the economy. We had an obligation to the American work force and the American businesses to get the economy on a stronger path. We've done it and we have time to deal with the deficit."

But the report said that even if the administration succeeded it would not be enough to address the long-term problems posed by retiring baby boomers.

Moreover, the fund economists said that the administration's tax cuts could eventually lower United States productivity and the budget deficits could raise interest rates by as much as one percentage point in the industrialized world.

"An abrupt weakening of investor sentiments vis-a-vis the dollar could possibly lead to adverse consequences both domestically and abroad," the report said.